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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1960

No. 413

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM 1960

No. --------

LYNNE ANDERSON WARREN and PEOPLES FIRST NATIONAL BANK and TRUST COMPANY (now PITTSBURGH NATIONAL BANK), Executors of Estate of JAMES M. SMITH, JR., Deceased,

Petitioners,

against

ALICE S. HIGGINS, on behalf of herself and other stockholders of SHENANGO POTTERY COMPANY (now SHENANGO CHINA, INC.), similarly situated, HILDA BARKBY, Administratrix of Estate of HARRY BARKBY, Deceased, and SHENANGO CHINA, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered[1] in the above case on May 10, 1960.

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[1] The certified record contains a Joint Appendix and a separate Consolidated Appendix whose page references are followed by "a" and "aa", respectively.

Opinions Below

The Adjudication of the District Court for the Western District of Pennsylvania dated April 26, 1956 and its Memorandum Granting New Trial dated Oct. 3, 1956 (neither reported) are at 261a-335a; the Opinion of the Court of Appeals dated June 24, 1958 (interim appeal) is reported at 256 F. 2d 504, and is also at 336a-347a; the Opinion of the District Court dated July 27, 1959 (not reported) is Appendix C. The Opinion of the Court of Appeals and its Judgment, both dated May 10, 1960, which are sought to be reviewed, are reported at 279 F. 2d 46, and are Appendix A and B.

Jurisdiction

The Judgment of the Court of Appeals was entered May 10, 1960. Timely petitions for rehearing were denied July 20, 1960.

The jurisdiction of this Court is invoked under 28 U. S. C. A. Sec. 1254(1).

Questions Presented

1. (a) Where a U. S. war contract is presented to a corporation and is unanimously declined by its board of directors in good faith and for valid business reasons, can an officer-director of the corporation openly, without fraud or deceit, and with unanimous approval of all the directors, then become interested in a partnership with outsiders which takes part of the contract and makes a fair arrangement with the corporation to perform the other part, all to the benefit of the corporation, the partnership, and the U. S. Government?

(b) May a Court of Appeals set aside the findings of fact of a Trial Court sitting without a jury, where the findings are not clearly erroneous?

2. (a) In an action for an alleged diversion of a corporate opportunity to an outside organization where there is no fraud, deceit or concealment, should fair compensation for the valuable services of defendants in managing the affairs of the outside organization be deducted before computing the profit of the outside organization?

(b) May a corporation retain benefits of a contract but repudiate the contract?

3. Does laches or the 6-year Statute of Limitations apply when a shareholder waits nearly 6 years before instituting a derivative action against officer-directors concerning a well-publicized corporate war contract?

4. Is an appeal in a shareholders' derivative action properly maintained where appellant-plaintiff fails to disclose to the Court of Appeals that she disposed of the bulk of her stock after the appeal was noticed, but prior to argument and decision?

Rule Involved

Rule 52(a) of the Rules of Civil Procedure (28 U. S. C. A.):

"Rule 52. Findings by the Court

(a) **Effect.** In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memo-

randum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b)."

Statement of the Case

In this shareholder's derivative action on behalf of Shenango Pottery Company, a Pennsylvania corporation located at New Castle, Pa. (Shenango), jurisdiction is based upon diversity of citizenship.

Petitioners are executors of the Estate of James M. Smith, Jr., deceased, a defendant who was President and a director of Shenango.

The facts, generally, are not in dispute: briefly, in January 1944, Shenango, a Smith family-owned manufacturer of china dinnerware, was invited to bid on a contract with the U. S. Army for the manufacture of land mines involving china and non-china techniques. After investigation, and for valid business reasons, Shenango declined. Defendant Treloar, a New Castle business man, revived the project and, with others, formed Castle Engineering Company (Castle) which took the non-china part of the contract, with Shenango, at Treloar's persuasion, taking the china part. Participation in Castle was offered to all Shenango directors and their families (who owned over 82% of Shenango's stock) including plaintiff, who was Smith Jr.'s sister, and whose husband was an officer and director of Shenango, but only Smith Jr. and two vice presidents, defendants Zahniser and Read (who was never served), became partners of Castle. The joint project was successfully completed during 1944—Shenango making a profit of over $248,000 and Castle, over $171,000. Plaintiff, as a shareholder, sued in January 1950, alleging a diversion of the contract. The other four defendants, including Treloar, were partners of Castle, but had no connection with Shenango. Barkby, holder of 2 shares of Shenango stock, intervened in mid-1950.

The case was actively before the same experienced Trial Court from Dec. 1953 to July 29, 1959. Its April 26, 1956 53-page Adjudication, with 167 specific findings of fact and 17 conclusions of law, as supplemented by its 10-page Opinion of July 27, 1959, states the facts in careful detail. Plaintiffs' evidence largely consisted of over 325 exhibits; defendants' evidence consisted largely of oral testimony.

The Adjudication dismissed all defendants except Smith Jr. and Zahniser, and although finding them free from fraud, deceit or concealment, and finding that the Shenango board of directors had originally declined the contract in good faith, held them liable to Shenango and entered judgment against them for Castle's profit before renegotiation, plus 6% interest from 1944. The theory of liability was that Smith Jr. and Zahniser were barred from participating in Castle "simply because it had been presented to Shenango" (412a) and for this technical rule, the Court relied on the 1955 case of *Greene* v. *Allen*, 33 Del. Ch. 508, 114 A. 2d 916. When it was brought out that this case had been *reversed* sub nom *Johnston* v. *Greene*, 121 A. 2d 919 (Del. 1956) just prior to the Adjudication, the Trial Court vacated the judgment and granted a new trial on the question of damages, although maintaining liability.

Meanwhile, an unusual departure from ordinary judicial procedure was taking place which has confused and complicated this case ever since, and seriously affected its proper disposition: at the close of plaintiffs' evidence in March, 1955, the Trial Court orally dismissed three of the non-Shenango defendants; the formal order of dismissal was not entered until Dec. 22, 1955, and in January 1956, plaintiffs filed an appeal to the Court of Appeals. At plaintiffs' request, action on this appeal was postponed until the Court of Appeals insisted it be heard. When, finally, a decision was handed down on this interim appeal on June 28, 1958 (336a-347a) the Trial Court had already filed its Adjudication, vacated its judgment and granted a new trial.

None of these matters was before the Court of Appeals in the interim appeal and petitioners were not a party to that appeal. The Court of Appeals held that a prima facie case had been made against the 3 defendants dismissed, and reinstated them. However, the Court (with Judges McLaughlin and Kalodner as a majority—Judge McLaughlin writing the opinion) stated (341a):

> "Plaintiff's above detailed evidence clearly points to a conflict between the Shenango officer and director defendants' obligation to their company and their self-interest. That evidence indicates those defendants used most every element of Shenango but the hotelware product itself for their own selfish interest."

After hearing additional evidence by all parties at the new trial, the Trial Court filed its opinion on July 27, 1959, in which it

(1) Discussed Judge McLaughlin's opinion in the interim appeal.

(2) Again dismissed the non-Shenango defendants.

(3) Again held Smith Jr. and Zahniser liable to Shenango on the same technical rule of law (now unsupported), in the reduced amount of Castle's profit of $181,603.71 after renegotiation, plus interest at 3% from 1944, and entered judgment for $262,456.58.

(4) Found that all defendants had acted openly and in good faith; the liability of Smith Jr. and Zahniser was "not based upon fraud and deceit under the evidence in this case"; the relationship between Shenango and Castle was in the nature of a "joint venture or common enterprise"; "the method of doing business was for the common good"; and the Shenango directors and Castle partners "had a bona fide desire to further the war effort." (Appendix C, pp. 26-27)

All parties appealed and the 5 appeals were heard together. On May 10, 1960, the Court of Appeals (Judges McLaughlin and Kalodner again the majority) affirmed except as to the dismissal of the non-Shenango defendants, as to which it reversed and ordered them reinstated. The opinion, again written by Judge McLaughlin, (Appendix A), not only disagreed with the Trial Court's finding of good faith in the original rejection of the contract as "clearly erroneous" but actually requoted Judge McLaughlin's statement from the interim appeal that "defendants used most every element of Shenango but the hotelware product itself for their own selfish interest."! (Appendix A, p. 12)

Petitions for Rehearing were denied without comment on June 20, 1960.

Reasons for Allowing the Writ

I. This case involves an important principle of corporate officer-director conduct in the everyday affairs of substantially all corporations; whether an officer or director may, in the absence of fraud, deceit and concealment, participate in an opportunity which, in good faith, has been declined by the corporation is a vital question which should be settled. A holding that under such circumstances an officer-director is forever barred has no basis in logic and would impose stifling impediments on progress. It is no wonder that such a holding is in conflict with every court that has considered the problem.

II. This case involves an equally important policy of this Court's supervision over a Court of Appeals which has set aside such a basic factual finding by an experienced Trial Court sitting without a jury as the good faith and credibility of witnesses who were seen and heard by the Trial Court. The rationale of Rule 52(a) of the Rules of Civil Procedure is a keystone of our judicial framework; if a Court of Appeals can ignore it with the unsupported

statement that the findings of the Trial Court are "clearly erroneous.", or recite unfounded illustrations to buttress this statement, Rule 52(a) is nullified. Here, the illustrations used by the Court of Appeals are unfounded, mistaken and unwarranted.

III. This case involves other important and generally applicable questions of law relating to proper accounting, laches and other matters which have been decided here, in conflict with other Courts of Appeals' decisions.

I. The Courts, since early times, have consistently held that where an opportunity has been declined by a corporation in good faith, an officer and director of the corporation thereafter may participate in the opportunity. Even in *Greene* v. *Allen*, *supra*, before its reversal, there was present a factor of domination and a failure to prove good faith, neither of which is present here.

In reversing that case (*Johnston* v. *Greene*, *supra*), the Chief Justice of Delaware said that the ultimate question in such a case is:

> ". . . the test of fairness."

Before *Greene* v. *Allen* was reversed, it was severely criticized in 31 *New York University Law Review* (February 1956) at pages 403-404:

> "The interest of a corporation in an offer made to it vanishes, however, after there has been a formal rejection of the offer by the board of directors (citing in a note: DuPont *v.* DuPont, 256 Fed. 129 (3d Cir. 1919); Diedrick *v.* Helm, 217 Minn. 483, 14 N. W. 2d 913 (1944)). Rejection of the offer by the corporation is generally a complete defense in an action against an officer, permitting the director to act with impunity . . ."

It is stated, in *Fletcher's Cyclopedia Corporations* (1947), Vol. 3, Sec. 8621, page 232:

> "Where a corporation declines because of legal barriers, to avail itself of an opportunity, or it is the

> settled policy of the corporation not to engage in a particular line of business, or it has declined the opportunity for business reasons, or the transaction is beyond the powers of the corporation, or the opportunity is not available to the corporation either because a party refuses to deal with it or because the corporation sought, but without success to obtain it, the opportunity is one in which the corporation has no legitimate interest or expectancy and may be embraced by an officer or director as his own."

In its Adjudication, the Trial Court squarely based its decision on *Greene* v. *Allen* (284a); after reversal of that case, when it came to write its opinion of July 27, 1959, it had no authorities but held to its theory of technical liability of Smith, Jr. and Zahniser by stating (Appendix C, p. 24):

> "Whether their liability be founded upon a statute, or a breach of their fiduciary relationship to Shenango, or whether it is based simply on public policy, in any event it is not based upon fraud and deceit under the evidence in this case. For purposes of this discussion, their liability is in the nature of *mala prohibita* only."

This is directly in conflict with *Cowell* v. *McMillin*, 177 Fed. 25 (C. C. A. 9, 1910). There, McMillin was president and director of a lime company which also had a barrel plant. A machine for making staveless barrels was offered to the Board of Directors and rejected. McMillin, individually, purchased the patent and made a contract with the lime company (he not voting) to lease its barrel plant to him and buy barrels from him. The Court said (p. 39):

> ". . . that McMillin acquired the title to the barrel machine in good faith with the knowledge and consent of the board of directors of the corporation, and after the board knew all that McMillin knew of the merits of the machine and had expressly refused to become interested in it; that there was no concealment from the board of directors on McMillin's part; that McMillin made the lease of the property and the contract for supplying barrels in good faith,

and that the contract when entered into was not unreasonable, unfair or illegal.

• • •

". . . Thus the case is brought within the rule recognized by the Supreme Court of the United States, namely, that where the director has acted with that candor and fairness which equity imposes as the guide for dealing between him and the corporation, and the transaction is open and free from blame, the director is not forbidden from making a contract with the corporation, or from entering upon a transaction in which he is personally interested. Twin Lick Oil Co. *v.* Marbury, 91 U. S. 587, 23 L. Ed. 328. See also Marshall on Corporation, Sec. 377; Figge *v.* Bergenthal, 130 Wisc. 594, 109 N. W. 582, 110 N. W. 798; Barr *v.* Pittsburgh Plate Glass Co., 57 Fed. 86, 6 CCA 260."

• • •

"Many of the cases cited by complainant's counsel in their brief upon the law are upon facts showing actual fraud . . . The principles of law therein announced do not apply to the facts in the case under consideration."[2] (p. 43)

The Trial Court's conclusion of liability is in error, as is its affirmance by the Court of Appeals, and is in conflict with the decided cases.

II. A Court of Appeals cannot disregard the fact findings of a District Court sitting without a jury unless the findings are clearly erroneous.

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[2] Also in conflict with: *Barr* v. *Pittsburgh Plate Glass Co.*, 57 Fed. 86, 6 CCA 260 (3d Cir. 1893); *Davis* v. *Pearce*, 30 F. 2d 85 (8th Cir. 1928); *Hirshorn* v. *Mine Safety Appliance Co.*, 203 F. 2d 297 (1953), cert. den. 346 U. S. 866; *Dupont* v. *Dupont*, 258 Fed. 129 (CA 3, 1919); *Sellers & Co.* v. *Clarke-Harrison, Inc.*, 354 Pa. 109; 46 A. 2d 497 (1946); *Black* v. *Parker Mfg. Co.*, 329 Mass. 105, 106 N. E. 2d 544 (1952); *Lincoln Stores, Inc.* v. *Grant*, 308 Mass. 417, 34 N. E. 2d 704 (1941); *Lancaster Loose Leaf Tobacco Co.* v. *Robinson*, 199 Ky. 313, 250 S. W. 997 (1923); see also *Hunt* v. *Aufderheide*, 330 Pa. 362, 199 A. 395 (1938).

It is obvious that the conclusion of the majority of the Court of Appeals in the interim appeal that defendants had selfish motives was too deeply implanted to be changed, even by an experienced Trial Court which, by an unusual turn of events, had the Court of Appeals' Opinion before it, and tried to show the conclusion incorrect!

When the Court of Appeals brushed aside these efforts and went so far as to requote from its opinion in the interim appeal, a situation arose which, so far as we can find, is without parallel. When it characterized Smith, Jr.'s phenomenal industry and candid conduct as "calculated indifference to the corporate common good" (Appendix A, p. 12) and Shenango's profit on the venture, of $248,587.58, as "Leaving behind a portion of the spoils . . ." (Appendix A, p. 5) it is evident that the Court of Appeals and the District Court are poles apart on the simple honesty of the men involved.

Rule 52(a) of the Rules of Civil Procedure provides, *inter alia*:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of witnesses."

Justice demands that this disagreement be resolved in favor of the Trial Court.

The principles stated by the late Mr. Justice Jackson in *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 70 S. Ct. 177, 94 L. Ed. 150 (1949), are particularly pertinent (p. 339):

> "Specifications of error which are fundamental to [the] case ask us to reweigh the evidence and review findings that are almost entirely concerned with imponderables, such as the intent of parties to certain 1929 business transactions, whether corporate officers were then acting in personal or official capacities, what was the design and purpose and intent of those who carried out 20-year-old transactions, and whether they had legitimate business motives or were intending to restrain trade of their

competitors in car manufacture, such as General Motors, Ford, Chrysler and Packard.

"These were the chief fact issues in a trial of 3 weeks' duration. The Government relied in large part on inferences from its 485 exhibits introduced by 9 witnesses. The defendants relied heavily on oral testimony to contradict those inferences. The record is before us in 1,674 closely printed pages.

". . . To us it appears to represent the considered judgment of an able trial judge, after patient hearing, that the Government's evidence fell short of its allegations—a not uncommon form of litigation casualty, from which the Government is no more immune than others.

". . . Findings as to the design, motive, and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them. . . ."[3]

It is not difficult to show that the illustrations used by Judge McLaughlin are, in themselves, "clearly erroneous". For example:

The fact that, on Feb. 21, 1944, the U. S. officials requested Shenango to take the contract in Shenango's name, is of vital significance. Plaintiff-respondents strove mightily throughout the trial to disprove this point. Defendants were able to produce disinterested witnesses of the calibre of Robert C. Downie, the U. S. Army colonel who, in 1944 was district chief of the entire Pittsburgh Ordnance District (testimony at 167aa-172aa) and Norman R. Schade, Chief of its Legal Branch (23aa-39aa), who completely corroborated Smith Jr., Zahniser and Treloar.

And yet, in the face of this uncontradicted evidence, Judge McLaughlin states (Appendix A, p. 3):

"It was then decided, *allegedly* at the instigation of Pittsburgh Ordnance, that Shenango's name be inserted in place of Castle . . ." (italics ours).

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[3] See *U. S. National Assoc. Real Estate Boards* (1950), 70 S. Ct. 711, 339 U. S. 485, 94 L. Ed. 1007; 111 A. L. R. 742; *Lassiter v. Guy F. Atkinson Co.*, C. A. Wash. 1949, 176 F. 2d 984.

Judge McLaughlin stresses that Smith Jr. "voted" on some matters, but ignores such formal requirements on other Shenango decisions. The Trial Court found (412a) that:

> "The dominating personality on the Board, according to all of the evidence, was not Smith Jr. but his father, James V. Smith, Sr. In no sense of the word could Zahniser and Smith Jr. be characterized as dominant or controlling directors."

The opinion states (Appendix A, p. 8) ". . . Smith Jr. forming a company to pick up the opportunity rejected by Shenango *on his recommendation and vote*;" and at p. 9: "Two of the three officers, Smith Jr. and Zahniser, who made the recommendation to Shenango *and voted on it*, subsequently formed Castle." (italics ours)

The evidence is uncontradicted that the original rejection of the land mine contract by the Shenango Board was an informal one. What the opinion ignores is that when the all-important Shenango Directors' meeting was held on February 21, 1944 to authorize the contract, Smith Jr. not only was not present and *did not vote*, but was in Pittsburgh, 50 miles away. The legal consequences of this are disregarded. Smith made no recommendation. He merely passed on the Government's suggestion to the Board. This nonparticipation could exonerate Smith Jr.

The Court of Appeals could not mean that Smith Jr.'s action on Feb. 21, 1944 is construed as "voting" on a matter in which he was interested. It is well settled that a director must attend the meetings of the board and act in person; he cannot vote by proxy.[4]

The opinion states that at the February 21, 1944 meeting the directors had "knowledge that Smith, Jr., one of

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[4] *Greenberg* v. *Harrison*, 143 A. 2d 216, 218, 143 Conn. 519 (1956); *Fletcher Cyc. Corp.*, Perm. Ed. Sec. 427; *Lippman* v. *Kehoe Stenograph Co.*, 11 Del. Ch. 80, 95 A. 895 (1915); *Dowdle* v. *Central Brick Co.*, 206 Ind. 242, 189 N. E. 145 (1934).

their number and son of the Chairman of the Board, was prime mover of Castle, . . . " (p. 8). Such reasoning is meaningless; if the other directors did *not* know of Smith, Jr.'s participation, such concealment should impose liability. The opinion is silent on the fact that Smith, Senior, dominated the Board and that the Board knew that the U. S. was desperate to get the job done. The Trial Court found (414a):

> "Having heard all of the evidence, however, I am under the strong impression that the Castle partners were not only looking for a profit but also had a bona fide desire to further the war effort. The members of the Shenango Board were also motivated by the same considerations."

The opinion refers to defendants' *argument* (Appendix A, p. 5):

> "Defendants *argue* that Shenango's profit is proof that they had the common good in mind and that there was no improper diversion of corporate opportunities; that the land mine project was in reality a joint venture between Shenango and Castle. *This argument* can be dismissed forthwith." (italics ours)

This is far more than "argument". The Trial Court *found* (413a):

> "The point has been raised and also discussed in Judge McLaughlin's opinion that Castle partnership is liable because the assets of Shenango were in the first instance used as credit in establishing Castle as a going concern. It is true, of course, and the evidence shows, that once the venture commenced all the interested persons active in the management of both Shenango and Castle exercised their energies in all directions in order to make a success of the land mine contracts. Materials were difficult to procure. Shenango had ample credit. It was easy to do business in Shenango's name and that was done. But that method of operation was not a surreptitious one. No secret was made of it. From

the commencement of the operation, it was just as much to the interest of Shenango that it be successful as it was to the interest of Castle. The venture proved a bonanza for Shenango as well as for Castle. The method of operation was done with the full cooperation of all members of Shenango's officers and directors. Judge McLaughlin in his opinion says on this subject:

> 'They could not deal with the funds and property of Shenango nor utilize the information and advantage of their officers for any but the common good.'

I hold that the method of doing business was for the common good and the result achieved proves the statement. * * *' It is apparent therefore, that the parties were in a business relationship in the nature of a joint venture or common enterprise. It should be observed, I think, that the parties were operating in war time. 'Conditions in business were far from normal." (italics ours)

Judge McLaughlin's opinion, in disagreeing with the Trial Court's finding of good faith, relied strongly on certain letters to the War Contracts Price Adjustment Board and a Petition to the Tax Court, all dated long after the contracts were completed. At most, these implied that Castle's partners, or some of them, had been functioning since January 1944, rather than February 1944 (the invitation to bid was dated Jan. 31, 1944 and received by Shenango a day or so later), and were determined by the Trial Court to be what they obviously are—statements made long after the event on a relatively unimportant point in the renegotiation bargaining—not prepared by the defendants but by a Washington lawyer. It is significant that Judge McLaughlin's opinion omits material favorable to defendants in a quotation from a letter dated December 30, 1944 signed by Treloar (Appendix A, p. 10). We reproduce the quotation and italicize the omitted material: (175-176a)

> "In the latter part of 1942 and early 1943 James M. Smith, Jr., Zeno Pfau and D. H. Treloar Jr., were investigating the possible adaptability of china and

porcelain to such war items as bombs, mines, etc. *Mr. Smith had developed an idea for an aerial practice bomb made of cast gypsum cement, and considerable time of these three men were devoted to presenting to procurement agencies the possibilities that such a bomb would have. Materials were plentiful and labor required for such an operation was sufficiently abundant to make the operation attractive. In addition, the critical shortage of metals and the pressing need for ammunition of all types added to the attractiveness of the proposed bomb. However, these efforts proved fruitless and the project was temporarily dropped.* During this formative period no formal organization existed and all expenses resulting from these efforts were paid by the individuals mentioned above."

The inclusion of the omitted material dispels the implication that the land mine project using china (as distinguished from a bomb made of cast gypsum cement) was considered back in 1942 or 1943.

The opinion also does a disservice to the Trial Court (Appendix A, p. 10):

> "The trial court bolstered this claim in its adjudication stating: 'It is clear and proven as an undisputed fact that the letter of January 31, 1944, from the Pittsburgh Ordnance District to Shenango was the first communication or actual notice to Smith Jr. of the land mine program.' However, this was contradicted by the trial court itself in its finding of fact No. 73, that 'At or about this time (late 1943 or January 1944 but prior to January 31, 1944) it was known at Shenango Pottery Company that a land mine using china parts was being made by Onondaga Pottery Company.' "

To classify the foregoing as a contradiction by the Trial Court should, we respectfully submit, be sufficient grounds on which to grant this petition. The Trial Court stated that the letter of January 31, 1944 was the first *official* communication from the Pittsburgh Ordnance District. It was also aware that the fact that Onondaga was engaged in a

land mine program was generally known at Shenango in January 1944 (263a):

> "On January 31, 1944, an invitation to bid on the manufacture and assembly of the AT-3 mine was sent by the Pittsburgh Ordnance District of the War Department to Shenango. This was the first *official* notice received by Shenango from the Ordnance District relative to the program, *although Shenango officers had heard rumors that other ceramic manufacturers were engaged* in such a program for the government." (italics ours)

The Trial Court did not contradict itself!

The opinion expresses astonishment (Appendix A, p. 11) that Shenango accepted the mine contract "only sixteen days after it rejected the same contract." First, it was not the same contract, for the involved procurement and intricate assembly was to be performed by Castle. Second, in war time a lot can happen in 16 days. After Feb. 5, 1944, when Shenango's Board declined the contract, Treloar and Smith Jr. worked against time to visit other manufacturers, line up space, contact suppliers, prepare and submit a bid, etc. By Feb. 21, 1944, Pittsburgh Ordnance was ready to award the contract to Castle! The opinion fails to mention a really astounding fact, i.e., that, starting from scratch after Feb. 6 or 7, 1944, Castle, mainly through Treloar and Smith Jr.'s round-the-clock activities, started shipping completed mines on May 18, 1944, and by July 31, 1944, had delivered the 100,000 mines called for in the contract, without a single rejection! (299aa, 301aa, 297aa).

The Court of Appeals relied on the case of *Tenth National Bank v. Smith Construction Co.*, 242 Pa. 269, as controlling. The Trial Court correctly ignored this case although plaintiff-respondent cited it repeatedly. There, the outside company performed no substantial services whatever, and was set up merely as a sham to divert profits. To hold that case applicable completely disregards not only

the Trial Court's findings but also the extraordinary and highly complimented services of Treloar and others in making the project a success and in fact, saving the whole land mine program. Shenango had no Treloar, or anyone even approaching his type of dynamic genius (257aa).

Finally, the opinion fails to comprehend or consider Smith Jr.'s utter lack of a motive to divert anything from Shenango. In January 1944, Smith Jr. held 419 shares of Shenango stock, or about 22% of the outstanding 1907.5 shares; his 2 daughters and wife held another 250 shares, for a combined total of 669 shares, or about 35% of the total. It is difficult to see where he would benefit by taking profits via Castle rather than via Shenango. As a stockholder of Shenango, he would have no personal liability, but as a general partner of Castle, his entire fortune (including his Shenango stock) would be at stake. Naturally, if the other directors of Shenango had taken a part in Castle, Smith's participation in Castle would have been reduced pro rata. As it developed, Castle's original bid included a 10% estimated profit on the first contract, or $73,300 (367aa). Smith, Jr. and Treloar were to divide equally 50% of the Castle profits in lieu of salary; thus, Smith Jr. could expect 25% of the *estimated* Castle profits or $18,325 *before* taxes, *if* it succeeded. If we add his wife's and daughters' Castle participation, about 15%, we get an aggregate amount of $29,000, or 40% of the *expected* Castle profit. There was no indication that there would be contracts in addition to the original contract. *By just sitting still*, Smith, Jr. and his family would get 35% of Shenango's profits; there is no reason why he should scheme to divert profits to get a maximum of 40% of Castle's profit and at the same time risk his entire fortune as a general partner. With the high war time taxes payable on any profits, the motives to divert are even weaker.

The Trial Court's findings of good faith were not erroneous, and were amply supported by the evidence.

The Court of Appeals' disagreement was clearly unwarranted. It is in strange contrast to the following excerpt from the Trial Court's Adjudication (275a):

> "Smith Jr.'s Estate and Zahniser have the burden of proving that the transactions which they entered into were done in good faith and that their acts were fair and free of fraud and consistent with the fiduciary obligation they owed to Shenango. See Hirshorn *v.* Mine Safety Appliances Co., 203 F. 2d 279 (3 Cir.). In this connection, as to the decision made soon after February 5th, *there is not a shred of evidence* which arises contemporaneously with the events and actions which took place, showing that Smith Jr. was disloyal or motivated by self-interest in reaching his own conclusion and in reporting to the other members of the board that it was best that Shenango not participate in the mine program. Plaintiffs' evidence on that score comes only from three exhibits, which are summaries made after the events occurred, and upon which little probative value is placed because of the purposes for which they were prepared.
>
> "Smith, Jr.'s deposition, and Zahniser's and Treloar's testimony indicate honesty of purpose in the decision reached. The testimony of Higgins and Love, who did not participate in Castle, is likewise clear and explicit on this point. All the directors were in accord on the subject, and according to Love, who was disinterested, Smith Jr. made no recommendation apart from the report made by himself, Zahniser and Love. There is no evidence whatsoever apart from the renegotiation exhibits, which ties in the previous activities of Smith Jr., Treloar and Pfau with a nonmagnetic mine. It is clear and proven as an undisputed fact that the letter of January 31, 1944, from the Pittsburgh Ordnance District to Shenango was the first communication or actual notice to Smith Jr. of the land mine program. The evidence is that he, Zahniser and Love, independently, but collectively, reached the same decision on inspection of Onondaga's operation. Their report to the other three directors and the then collective decision of the six members of the board rested upon the facts then before them, with no conflict of interest on any-

> one's part so far as the evidence shows. Their decision in the first instance then, is held to be one based upon the exercise of their business judgment alone. That judgment is not subject to attack by minority shareholders *because under the preponderance of the evidence they fulfilled the statutory duty required of them in that they did* ' * * * *discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs.*' See Section 408, Pennsylvania Business Corporation Law of May 5, 1933, P. L. 364, § 408, 15 P. S. 2852-408." (italics ours)

III. A. In computing Castle's profits, the compensation paid to Smith Jr. and Treloar by Castle should have been credited as a proper expense of operation.

B. Shenango should not retain the profits of the land mine contracts and, at the same time, repudiate the contracts.

The Trial Court stated (417a):

> "I do not regard such a credit as proper under the facts of the situation."

The Court of Appeals affirmed this without discussion (Appendix A, p. 17). This holding is in direct conflict with the decision of the Court of Appeals for the 7th Circuit in the case of *Central Ry. Signal Co.* v. *Longden*, 194 F. 2d 310 (1952), which involved a diversion of a war contract.

The Trial Court found that Smith Jr. and Treloar performed all management and supervisory functions for Castle (294a). Since this was a partnership, no salaries as such were paid to them as partners. However, there was an agreement among the partners that Smith Jr. and Treloar should receive a total of one-half (or one-fourth each) of the net partnership profits in lieu of salary (221-222aa); under this agreement each received, after renegotiation, $42,765. (367aa, back). There is no question that

if Castle had been a corporation, the salaries paid them as the principal executive officers would have been deducted before determining the net profits which Castle was obligated to repay to Shenango.

It would be unfair for Shenango, which itself made a profit of $248,587.58 to recover the entire profit of Castle without any deduction for the invaluable services of Smith Jr. and Treloar. To do so would enable Shenango to obtain these services free.

The Trial Court found both of these men free from fraud, industrious and patriotic (412a, 414a). Yet, even in cases where there was grossly fraudulent conduct, the courts have recognized the propriety of allowing compensation for services.

In *Central Ry. Signal Co.* v. *Longden*, *supra*, defendant Longden was president and dominant director of plaintiff Signal Co. He organized a personally owned company (Victory Corp.) and took for it a corporate opportunity of Signal Co. by misrepresenting it as a subsidiary of Signal Co. These proceedings were concealed from his directors. The lower court of course, found him guilty of a breach of his fiduciary duty to Signal Co., and directed that he pay all profits from the transaction, including the salaries he received from Victory Corp. The Court of Appeals, however, in spite of his concealment, misrepresentation, and fraudulent conduct, said (p. 323):

> "The trial court ordered Longden to repay to Victory the salaries drawn by him as its president during the years of its operation and thereafter from September 1942 to June 30, 1949, totalling $84,000. There is no evidence that Victory's operations were not properly managed. They involved production of some $5,000,000 worth of ammunition for the United States. Such undertakings are not self-operating; they involve tremendous executive and administrative activities. Longden, president and general manager discharged those functions. No complaint is made of his efficiency, his ability or his

> success. Though we agree that the earnings of Victory belong to plaintiff, we can conceive of no reason in equity why the reasonable actual costs of management, administration and production, from which sprang the profits, should not be allowed. These include the salaries and wages of all contributing to the final result,—a profitable operation. Those expenses, those salaries, would have had to be paid if plaintiff itself had conducted the enterprise; they are a part of the cost of goods sold. . . . We know of no reason in equity why any of this compensation paid to him by Victory between January 1, 1942 and June 30, 1949 should be repaid. The chancellor should have allowed the reasonable cost of the undertaking, including reasonable salaries for the executive officers. Inasmuch as no attack is made upon the reasonableness of the sums paid, equity demands that the judgment for repayment of salaries paid to Mr. Longden be reversed. Otherwise plaintiff would be unduly enriched."

The same principles apply to partnerships: *Edelson v. Bernstein, et al.*, 2 D. & C. 2d 443, affirmed on opinion below, at 382 Pa. 392 (1955).

It would be clearly inequitable to enrich Shenango unjustly by giving it the entire profits of the Castle operation without allowing fair compensation for the management services of Smith Jr. and Treloar which created those profits. This is a substantial matter: the compensation to Smith Jr. and Treloar was $42,765 each, or an aggregate of $85,531 which, with 3% interest from 1944 to July 27, 1959 would total around $112,000.

It is also repugnant to justice and fair dealing that a party retain the benefits of a transaction and at the same time repudiate that transaction as respects the rights of others thereunder. *Presbyterian Board v. Gilbee*, 212 Pa. 310, 314, 61 A. 925 (1905); *Cameron v. Christy*, 286 Pa. 405, 411, 412, 133 A. 55 (1926); *Ketcham et al., Aplnts. v. Conneaut Lake Co.*, 309 Pa. 224, 232, 233, 163 A. 534 (1932); *Bailis et al. v. Reconstruction Finance Corporation*, 38 F.

Supp. 721, 725, affirmed 128 F. 2d 857 (C. C. 3, 1942). If Shenango repudiates this transaction, its $248,587.58 of profits should be a credit against any recovery from Castle.

IV. Plaintiff-respondent stockholder was guilty of laches in waiting nearly 6 years before instituting action.

The Trial Court disregarded the question of laches. The Court of Appeals in its interim opinion stated (347a):

> "Laches is not an element in the pending litigation. Shenango's right to recover at law was governed by the Pennsylvania six year statute of limitations. The action before us was commenced well within that period."

At that stage of the proceedings, defendants' evidence had not been developed. To hold that only the Statute of Limitations is applicable is in conflict with the decisions of other Courts of Appeals and also of the courts of Pennsylvania.

Plaintiff-respondent's familiarity with the Shenango-Castle joint enterprise from 1944 on (149aa) and her bargaining activities where she asked a fantastic price for her Shenango stock (373aa) in the years preceding the filing of this action in January, 1950 are clear. The cause of action, if any, arose no later than February 21, 1944, the date when the Shenango directors (including plaintiff's husband) approved the Army's request that Shenango be substituted for Castle as prime contractor (40aa). She offered no explanation for her delay in bringing suit (67aa); and, in fact, did not take the witness stand in spite of the admission of her counsel that her testimony would be relevant to the question of laches (94aa).

In *Kinter, Appellant* v. *Commonwealth Tr. Co.*, 274 Pa. 436, 118 A. 392 (1922), plaintiff stockholder accused defendant corporate officers of inducing him to sell his stock by concealing the fact that the corporation had secured valuable war contracts. Suit was filed 5½ years after

the sale of the stock but within the six year statute of limitations. The court said (pp. 439-440):

> "The decree must be affirmed on the ground of laches and it is unnecessary to consider other questions. He who would rescind a contract by reason of fraud must act promptly . . . In the instant case, for nearly six years after plaintiff gave the option and five years after he transferred the stock, he remained silent and inert . . . Equity will not lend its aid to one who has slept upon his rights until the original transaction is obscured by lapse of years and death of parties . . . The burden here was upon plaintiff to set out such facts as would excuse his laches; yet he does not attempt to do so."

See also *Hornsby et al. v. Lohmeyer*, 364 Pa. 271, 277, 72 A. 2d 294 (1950).

Plaintiff made no attempt to explain why she waited 5 years and eleven months to bring suit; intervenor Barkley did not join in the proceedings until after the six-year period had run. In the meantime, defendants paid income taxes on the profits received from Castle (176aa, 369aa, back) and the time for amending the returns passed; thus, they materially and irretrievably altered their positions. Moreover, Smith Jr. and Smith Sr., his father, died pending the trial of the case (57aa).

Voicing objections alone, without taking action, is not enough (173aa); in *Watts's Appeal*, 78 Pa. 370 (1875), the Court held that laches barred plaintiff from bringing suit some two years after the construction of the building of which he complained.

The Third Circuit Court of Appeals, in *Barr v. Pittsburgh Plate Glass Co., supra*, in dismissing a charge that directors should not participate in a project turned down by the corporation, stated at p. 98:

> ". . . It must not be overlooked, too, that in reference to the purchase of Tarentum the proceedings to set it aside, or to alter the terms thereof, were

not taken until after the lapse of more than two years from the execution of the contract, a delay which, of itself and unexplained, might be fatal to that portion of the plaintiff's complaint. *Oil Co.* v. *Marburg*, *supra*."

V. In this shareholders' derivative action an appeal is not properly maintained where plaintiff-respondent shareholder did not disclose to the Court of Appeals that she had disposed of the bulk of her Shenango stock after she had filed this appeal and before argument or decision.

This was brought to the attention of the Court of Appeals in a petition for rehearing and ignored without comment. The facts alleged, on information and belief, were that plaintiff, her two sons and her husband had sold 282 shares for $452,800, less nominal transfer taxes, and plaintiff retained about 3% of the total stock, or about 5% of one class of stock, evidently to comply with the Pennsylvania Act of 1945, P. L. 253, 12 Purd. Stat. 1321 as to minimum amounts of stock required to avoid the necessity of a bond for costs. This is in direct conflict with the spirit of Rule 23 of the Rules of Civil Procedure (28 U. S. C. A.). The jurisdiction of the Court of Appeals is in doubt whenever it appears that an appeal may be collusive, not in good faith, and improperly maintained. This matter should be settled by this Court.

Conclusion

For the reasons set forth above, this petition for a writ of certiorari should be granted.

Respectfully submitted,

LYNNE ANDERSON WARREN,
Counsel for Petitioners.

September 12, 1960.

Appendix A—Court of Appeals Opinion

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

Nos. 13,026, 13,027, 13,060, 13,061, 13,062

ALICE S. HIGGINS, PLAINTIFF, ON BEHALF OF HERSELF AND OTHER STOCKHOLDERS OF SHENANGO POTTERY COMPANY, SIMILARLY SITUATED; AND HILDA BARKBY, ADMINISTRATRIX OF THE ESTATE OF HARRY BARKBY, DECEASED,

Intervenor,

v.

SHENANGO POTTERY COMPANY, NOW SHENANGO CHINA, INC., A CORPORATION; JAMES M. SMITH, JR., GEORGE B. ZAHNISER, CHARLES W. READ, DANIEL H. TRELOAR, JR., ZENO J. PFAU, JOHN B. McCARTY AND ALVAH M. SHUMAKER, INDIVIDUALLY AND JAMES M. SMITH, JR., GEORGE B. ZAHNISER, CHARLES W. READ, DANIEL H. TRELOAR, JR., ZENO J. PFAU, JOHN B. McCARTY AND ALVAH M. SHUMAKER, TRADING AS CASTLE ENGINEERING COMPANY, A PARTNERSHIP, LYNNE ANDERSON WARREN AND PEOPLES FIRST NATIONAL BANK AND TRUST CO., EXECUTORS OF ESTATE OF JAMES M. SMITH, JR., DECEASED,

Defendants.

ALICE S. HIGGINS, ETC. AND HILDA BARKBY, ETC., APPELLANTS IN NO. 13,026 AND NO. 13,027

SHENANGO POTTERY COMPANY, NOW SHENANGO CHINA, INC., A CORPORATION, APPELLANT IN NO. 13,060

LYNNE ANDERSON WARREN AND PEOPLES FIRST NATIONAL BANK AND TRUST CO., EXECUTORS OF ESTATE OF JAMES M. SMITH, JR., DECEASED, APPELLANTS IN No. 13,061

GEORGE B. ZAHNISER, APPELLANT IN No. 13,062

APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Argued March 25, 1960

Before McLAUGHLIN, KALODNER and HASTIE, *Circuit Judges*.

OPINION OF THE COURT

(Filed May 10, 1960)

By McLAUGHLIN, *Circuit Judge*.

The facts in this case are set forth at length in Higgins, et al. v. Shenango Pottery Co., et al., 256 F. 2d 504 (3 Cir. 1958), but for clarity a resume is appropriate.

This is a derivative action brought by a stockholder of Shenango Pottery Co., a Pennsylvania corporation, (Shenango) engaged in the manufacture of chinaware. Several of the defendants were officers and directors of Shenango: James M. Smith, Jr., now deceased, son of the founder and Chairman of the Board, James M. Smith, Sr., was a director and president; George B. Zahniser, a nephew of Smith, Sr., was a director and vice-president; Charles W. Read, since dismissed as a defendant by stipulation, was a director and vice-president. The remaining individual defendants were in no way connected with Shenango: Daniel H. Treloar, Jr. was in the life insurance business; Zeno J. Pfau was an automobile dealer; Alvah M. Shumaker was an attorney; and John B. McCarty was a

bar manager. The principal plaintiff, Alice S. Higgins, daughter of Smith, Sr. and sister of Smith, Jr., is a minority stockholder of Shenango.

On January 31, 1944 the Pittsburgh Ordnance District of the War Department offered Shenango the opportunity to participate in a non-magnetic land mine program. The principal parts of the mine, the bell and base, were to be ceramic, large and heavier than ordinary dinnerware and involved an operation foreign to the manufacture of dinnerware, that of threading the parts to fit with other pieces. On February 5, 1944 Smith, Jr., Zahniser and James K. Love, the latter another director of Shenango but not a party here, traveled to the Onondago Pottery Company in Syracuse, New York to investigate the land-mine program already in operation at that firm. Based on this investigation they recommended to the remaining three directors, Smith, Sr., Jonathan Higgins, husband of the principal plaintiff and Charles W. Read, that Shenango refrain from entering the land mine program.[1] The considerations prompting this recommendation ostensibly were a complicated assembly operation, rigid government tests and a requirement of additional space and labor. As a result the Board decided it was not feasible for Shenango to bid for a mine contract.

Several days subsequent to the decision, Smith, Jr., Treloar and Pfau investigated the possibility of undertaking the manufacture of mines and, as a result, began formation of a corporation, Castle Engineering Company (Castle). Castle submitted a bid which was not acceptable to Pittsburgh Ordnance because Castle was not as yet a

[1] It was brought out at the trial, on cross-examination of Zahniser, that at this time Smith, Jr. believed the operation could be profitable:

"Q. Did he [Smith, Jr.] tell you that he believed that the assembly job could be done profitably? A. He did, he told me that he got that impression by his trip to the Onondago and to the Ohio Brass Company. * * *

Q. And that was after paying Shenango Pottery $2.00 a pair for the ceramic parts? A. That is correct."

corporate entity. It was then decided, allegedly at the instigation of Pittsburgh Ordnance, that Shenango's name be inserted in place of Castle and upon award of the contract to Shenango, to have it sublet to Castle. Smith, Jr. immediately telephoned Shenango from Pittsburgh and had the proposal put before the other five members of the Board who were present at Shenango. The Board approved. On this point, the district court found, as a conclusion of law, that the business judgment of the five board members was influenced by the knowledge that Smith, Jr. and two other directors and officers of Shenango, Zahniser and Read who had previously joined with Smith, Jr., Trefoar and Pfau, were interested in Castle. The contract was awarded to Shenango which in turn sublet it to Castle, with the exception of the part calling for the manufacture of the ceramic base and bell. These parts Shenango was to supply at two dollars for every pair accepted and paid for by the government. At this stage it would be well to outline the full import of that arrangement.

The government inspection of the land mines consisted of a waterproof test and a drop test. Five mines were submerged in water for twenty-four hours, at the end of which time they were disassembled. If any trace of water was found, ten more were put through the same test and if water was found in any one of the ten the entire lot was rejected. After that five mines were dropped from a prescribed height on to concrete. If there was a failure of any of the parts of more than one mine, ten others were tested. If three or more of the fifteen showed failure the entire lot was rejected. Castle contracted to have the inspection on the basis of a lot consisting of ten thousand mines. Thus if either test was failed the entire ten thousand mines would have been rejected and Shenango would not receive payment for any of the ten thousand pairs of bases and bells, which were the most expensive part of the mine. It should be further noted that although the contract was sublet, Shenango remained liable thereon.

Appendix A—Court of Appeals Opinion

Castle was reorganized into a limited partnership; Smith, Jr. and Treloar becoming the general partners and Zahniser, Pfau and Read, later joined by Shumaker and McCarty, being the limited partners. It had a stated paid-in capital of $50,000 of which only $32,200 was actually paid in by the end of the fiscal year, July 31, 1944. The question of the validity of the limited partnership was raised. However, it is irrelevant since in our previous opinion we stated that the liability of the limited partners for return of improperly received profits is not limited by the amount of their partnership contribution. 256 F. 2d at 510.

Castle drew heavily on the financial resources of Shenango, and in many of its negotiations used the name, reputation and credit rating of Shenango. The trial court found that even the bid submitted by Castle contained information descriptive of Shenango but the court felt the constant use of Shenango's name was merely carelessness; a conclusion not borne out by the record.

Castle subsequently was awarded two other contracts, one of which was terminated with a monetary allowance before any land mines were supplied under it, both of which contracts the court held were corporate opportunities diverted from Shenango. The total net profit to Castle was $326,603.71 in a little over nine months.[2] Eventually this was reduced, as excessive profit, to $181,603.71 on renegotiation by the War Contracts Price Adjustment Board. Shenango made a profit of $248,587.58 on the manufacture of the base and bell. This was not renegotiated. Defendants argue that Shenango's profit is proof that they had the common good in mind and that there was no improper diversion of corporate opportunities; that the land mine project was in reality a joint venture between Shenango and Castle. This argument can be dismissed forthwith. Leaving behind a portion of the spoils is hardly justifica-

[2] From this amount was deducted a $10,000 liquidation expense leaving a net operating profit of $316,603.71.

tion. It leaves unanswered much the same question as arose in Tenth National Bank v. Smith Construction Co., 242 Pa. 269, 287 (1913). There officers of the Smith Company formed a partnership, the Maryland Company, to furnish services and supplies to the Smith Company at a profit. The court stated:

> "* * * the 10 per cent. paid to the Maryland concern might have been saved to the Smith Company; in substance it was nothing more or less than a commission for services that could have been performed directly by the officers of that company. Again, if the Maryland Company could furnish coal and horses to the Smith Company at a profit, it has not been made plain why the men who constituted that concern did not perform this service directly as officers of the latter corporation, and thus save to it the amount of such profits. Cases may be cited where the officers of a corporation have been permitted to make and retain profits for themselves through the formation of outside agencies controlled by them, which profits they could have saved to their constituent company had their thought been only for its welfare; but in such instances the law has ceased to look at the mere form of the device employed —it now pierces through the surface and seizes upon the evils which lie within."

On January 5, 1950, after several futile demands that the Board of Directors act to recover profits diverted from Shenango to Castle, plaintiff instituted this stockholder's derivative action. At the close of plaintiff's evidence the district court dismissed the suit against defendants Pfau, McCarty and Shumaker under Rule 41(b), Fed. R. Civ. P. The plaintiff appealed and this court, in an amended opinion filed June 24, 1958, reversed and remanded the cause. 256 F. 2d 504. However, prior to our decision, the district judge on May 23, 1956 pursuant to a lengthy adjudication which include 111 findings of fact and 17 conclusions of law found defendant Treloar not liable on the merits and gave judgment against the Estate of Smith, Jr. and Zahniser, jointly

and severally, in the sum of $316,603.71 with interest at 6% which totaled $538,396.99. Then on October 3, 1956, the district judge granted a new trial on the issue of damages only. The matter came on for trial in March of 1959. Because of this court's remand, evidence was taken on the issue of liability of the defendants, Pfau, McCarty and Shumaker. And since final judgment had not been entered in favor of Treloar, the question of his liability was reopened.

On July 29, 1959 the district court entered an amended order for judgment again exonerating Treloar, Pfau, McCarty and Shumaker, and holding Zahniser and the Smith, Jr. Estate liable. As to damages the court determined these to be Castle's profit after renegotiation with the War Contracts Price Adjustment Board, namely, $181,603.71. It fixed the rate of interest at 3%, rather than 6%, from the date the profits were realized. Including interest, the damages amounted to $262,456.58.

Plaintiff appeals from that part of the judgment dismissing the defendants Castle, Pfau, Treloar, McCarty and Shumaker and reducing the amount of damages. Defendant Shemango appeals from the judgment dismissing the above named defendants. Defendants Zahniser and the Estate of Smith, Jr. appeal from the judgment entered against them. As set out in the opinion of the district judge, this litigation is in such posture that should we disagree with the judgment below or any part thereof, we may direct whatever judgment as is required by the evidence and the law.

The questions in the various appeals can be divided under three major headings: The liability of Zahniser and the Estate of Smith, Jr.; the liability of the other defendants; and the amount of damages.

Liability of Zahniser and Smith, Jr.

The trial judge considered the inspection and recommendations made by Smith, Jr., Zahniser and Love, and the

resulting action of the entire Board determining it would not be feasible for Shenango to enter the mine program as having been made in good faith and as a business judgment. However, the subsequent events: Smith, Jr. forming a company to pick up the opportunity rejected by Shenango on his recommendation and vote; Zahniser joining him and later Read; the Directors of Shenango, upon Castle's bid being rejected, reversing their previous decision and with knowledge that Smith, Jr., one of their number and son of the Chairman of the Board, was prime mover of Castle authorizing Smith, Jr., to bid in the name of Shenango for the benefit of Castle; these events, the court found, demonstrated that Smith, Jr. and Zahniser, knowing that either Shenango or Castle had a prospect of making a profit were then in a conflicting position and, being in a fiduciary relation to Shenango should have refrained from participating in Castle. The trial court went on to find that their association in Castle was a breach of a fiduciary duty but done in good faith.

We disagree. Considering those transactions following the original Board decision to reject the contract as separate and distinct from the events leading up to and including the original decision merely ignores the bad faith which permeates the entire scheme.

That the Board on February 5, 1944 rejected the mine program in good faith and as a business judgment is in no way dispositive; the important question is the good faith of Smith, Jr. and Zahniser in making the recommendation upon which the decision was based. This recommendation was, according to testimony of Zahniser, based on a half-day's inspection of the mine operation at Onondago Pottery Company. Yet, before organizing and submitting a bid for Castle, Smith, Jr. with Trefoar and Ptau, inspected the mine operation at Ohio Brass Company, Barberton, Ohio, determined the price per mine at which the Army intended to let the contracts, estimated at which price they could buy the ceramic parts and still make a profit, began planning for

the necessary equipment, contacted various suppliers of parts and machinery, determined the availability and price of parts and searched for available space needed for the assembly. Two of the three officers, Smith, Jr. and Zahniser, who made the recommendation to Shenango and voted on it subsequently formed Castle. According to Zahniser, the recommendation and decision not to participate were made because of the problems of space, availability of labor and the complexity of the assembly operation. These very problems were quickly overcome by Castle, and the trial court found as a fact that the project was well within Shenango's corporate capabilities. It is impossible to understand why these problems made it unfeasible for a large, financially sound corporation like Shenango to enter the program when the embryo organization, Castle, under the guidance of Shenango's president reaped a tidy profit in like circumstances.

Plaintiff introduced into evidence letters sent to the War Contracts Price Adjustment Board and a Petition to the Tax Court for redetermination on behalf of Castle, which indicate that Smith, Jr., Treloar and Pfau were interested in the mine program even before the opportunity was offered the Shenango on January 31, 1944. By letter dated January 19, 1946 Castle's attorney requested a review of the Adjustment Board's determination stating therein, in part:

> "The operations of the Company, which is a partnership, actually started early in January, 1944, through the individual efforts of Mr. James M. Smith and Mr. Daniel H. Treloar, Jr., the unlimited partners * * * They began devoting all of their time to setting up for production of the mines long before March 22, 1944, the date on which the partnership was formally organized * * *."

The Petition for redetermination to the Tax Court of the United States contained the following allegations:

"6. (o) The respondent erred in disregarding the fact that, although not then formally organized, the petitioner had actually been functioning and the petitioner's general partners has (sic) been performing services, since January, 1944.

7. * * * (a) * * * The members of the petitioner had been jointly engaged in preliminary work on said mine program since January, 1944."

The above was sworn to be a true statement by Smith, Jr., Treloar, Pfau, Zahniser, Read, McCarty and Shumaker.

A letter dated December 30, 1944 to the Price Adjustment Division of Pittsburgh Ordnance District signed by Treloar on behalf of Castle included the following:

> "In the latter part of 1942 and early 1943 James M. Smith, Jr., Zeno Pfau, and D. H. Treloar, Jr., were investigating the possible adaptability of china and porcelain to such war items as bombs, mines, etc. * * * During this formulative period no formal organization existed and all expenses resulting from these efforts were paid by the individuals mentioned above."

The trial court felt that the above were "* * * summaries made after the events occurred, and upon which little probative value is placed because of the purpose for which they were prepared." These were statements, one sworn, made to a government agency and the Tax Court indicating a pre-existing interest in the very program later rejected by Shenango on Smith, Jr.'s recommendation. This evidence was contradicted by the deposition of Smith, Jr. and the testimony of Treloar and Pfau to the effect that the land mine program was first discussed among the three, casually over lunch, sometime after Shenango rejected the opportunity. The trial court bolstered this claim in its adjudication stating: "It is clear and proven as an undisputed fact that the letter of January 31, 1944, from the Pittsburgh Ordnance District to Shenango was the first communication or actual notice to Smith, Jr. of the land mine

program." However, this was contradicted by the trial court itself in its finding of fact No. 73, that "At or about this time [late 1943 or January 1944 but prior to January 31, 1944] it was known a Shenango Pottery Company that a land mine using china parts was being made by Onondago Pottery Company."

Added to all of the above is the astounding fact of the Shenango Board of Directors suddenly accepting the mine contract, after a telephone call from Smith, Jr. only sixteen days after it rejected the same contract. Shenango, outstanding in its field, at the time the largest producer of pottery in the world, first refuses to enter into a contract because of the difficulties involved and immediately thereafter, agrees to accept full liability under the same contract, *the liability hinging solely on the success or failure of a new, untried firm existing only on paper.* It was as to this later decision that the trial court found the business judgment of the Board was influenced by the knowledge that three of the Board members were organizers and owners of Castle.

Officers and directors are deemed, by the law of Pennsylvania which controls, to stand in a fiduciary relation to the corporation. 15 P. S. § 2852-408. As pointed out in our previous opinion at pages 507 and 508:

> "They [the directors and officers] were bound to act in the utmost good faith. They could not deal with the funds and property of Shenango nor utilize the influence and advantage of their offices for any but the common good. If they made a personal profit through the use of Shenango's assets they were accountable for it to the stockholders; they were not permitted even to place themselves in a position which invited conflict between their self-interest and their integrity." (citing Lutherland, Inc. *v.* Dahlen, 357 Pa. 143 (1947); Bailey *v.* Jacobs, 325 Pa. 187 (1937)).

In view of all the circumstances we reaffirm what we previously said:

"Plaintiff's above detailed evidence clearly points to a conflict between the Shenango officer and director defendants' obligation to their company and their self-interest. That evidence indicates those defendants used most every element of Shenango but the hotel-ware products itself for their own selfish interest."

The actions of defendants, Smith, Jr. and Zahniser, while short of fraud or deceit, were in calculated indifference to the corporate common good. We agree with the trial court that both are liable but the further finding of good faith is clearly erroneous and is set aside.

Liability of the Other Defendants

We held in our first opinion that the limited partners would be liable, jointly and severally with the general partners irrespective of their limits of liability, if the partnership is found to be liable. 256 F. 2d at 509-510. However, the district court considered that the limited partners were not liable and "That being so, it necessarily follows that Castle Engineering Company as a partnership entity is not liable." That is the reverse of the proposition we set forth. The Uniform Partnership Act, 59 P. S. § 34 states: "Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind * * * operate as notice to or knowledge of the partnership * * *." The evidence is indisputable that Smith, Jr., Zahniser and Read, the corporate fiduciaries, had knowledge or should have had knowledge of their breach of duty and such knowledge was acquired while partners in Castle and while acting in partnership affairs. This is knowledge of the partnership and "The partnership in such situation would be liable for any profits realized from a breach of their fiduciary duty by a number of the partners for the purpose of benefiting the partnership at the expense of Shenango." 256 F. 2 at

509-510. The general partner, Treloar, and the limited partners Pfau, McCarty and Shumaker are jointly and severally liable with Smith, Jr. and Zahniser for the profit improperly diverted from Shenango.

These latter four defendants are also liable on the theory of constructive trust:

> "Where a fiduciary in violation of his duty to the beneficiary transfers property or causes property to be transferred to a third person, the third person, if he gave no value or if he had notice of the violation of duty, holds the property upon a constructive trust for the beneficiary." Restatement, Restitution § 201(1). See Spivak *v.* Bronstein, 367 Pa. 70, 75-76 (1951); Columbia Cas. Co. *v.* Westmoreland Co., 365 Pa. 271, 274 (1950).
>
> "Notice need not be actual. A purchaser is chargeable with notice of the trust where the facts and circumstances existing at the time of the purchase, within his knowledge, are such as would put a man of ordinary prudence upon inquiry and require him to make an investigation, and he fails to do so * * * no particular kind of evidence is necessary to constitute notice." Cameron *v.* Peoples' Bank of Maytown, 297 Pa. 551, 556-557 (1929). Columbia Cas. Co. *v.* Westmoreland, supra at 274; Custis *v.* Serrill, 303 Pa. 267, 270 (1931).

In *Spivak v. Bronstein*, *supra* 74-75, a taproom and restaurant owner continued a partnership arrangement with the administratrix of his former partner's estate. There the court said:

> "The agreement was with a fiduciary whose limitations to enter into such a contract defendant was bound to know * * *. Defendant should have known that without approval of the court, the contract he entered into with the plaintiff afforded him no protection against anyone beneficially interested in the estate * * *. So also he was bound to know that the minor son of his deceased partner could act only through his lawfully appointed guardian. He was bound to know also that

the mother could not under the law have been appointed guardian because of incapacity both as parent and as administratrix."

The inquiry which faced defendants here was much less stringent than that demanded by the court in Spivak. "A person has notice of a fact if he knows the fact, has reason to know it, should know it, or has been given notification of it." Restatement, Agency 2d § 9(1).

> "A person has reason to know of a fact if he has information from which a person of ordinary intelligence * * * would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. The inference drawn need not be that the fact exists; it is sufficient that the likelihood of its existence is so great that a person of ordinary intelligence * * * would, if exercising ordinary prudence under the circumstances, govern his conduct as if the fact existed, until he could ascertain its existence or non-existence." Restatement, Agency 2d § 9, Comment (d).

Treloar, as a general partner, had all the facts at his command. The other three limited partners had knowledge of the circumstances sufficient to spur them to inquiry. They made little or no investigation.[3] They cannot be allowed to

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[3] John B. McCarty testified:

"Q. You knew he [Smith, Jr.] was an officer and director, did you not? A. I knew he was connected with the pottery, yes, sir.

Q. And you knew that Mr. Zahniser was an officer and director, did you know that? A. I know Mr. Zahniser was connected with the Pottery, but I didn't know he was an officer to be truthful with you.

Q. Did you know he was a director? A. No, I didn't.

Q. Did you know Mr. Reed was an officer and director? A. I knowed Mr. Read was, yes, sir.

escape responsibility because they, in effect; say they closed their eyes to the obvious. All are jointly and severally liable with Smith, Jr. and Zahniser.

Q. Mr. McCarty, knowing that Mr. Zahniser and Mr. Smith, Jr. and Mr. Read were connected with Shenango and were also connected with Castle Engineering did you do anything to try to find out what the facts were in the situation so as to determine whether it was all right to be in that land mine project? A. No, I didn't.

Q. You made no inquiry? A. I wasn't interested. I didn't know a thing about what went on with the land mines at all.

Q. Did you make any inquiry as to the relationship between Shenango and Castle Engineering Company? A. No, sir."

Zeno Pfau testified:

"Q. Did you know, Mr. Pfau, that Shenango Pottery Company did take the first land mine contract itself, did you know that? A. No. Yes, I did too.

Q. I beg your pardon. A. I believe I did. I believe I was told that they took it to hurry up the order, as I understand it. Now, I don't remember that in detail. I wasn't too much consulted on this.

Q. What is your best recollection as to what you were told about Shenango taking the first land mine contract? A. I possibly didn't know about it until after it happened. I don't know."

Alvah M. Shumaker testified:

"Q. Well, now, you say that you were aware of the possible conflict of interest but you came to the conclusion that in this particular case there was no reason to be concerned, or words to that effect, is that correct? A. Well, let's say words to that effect.

Q. Then your last answer was—— A. Yes.

Q. Now, I will ask you then; being on notice of a possible conflict of interest will you tell me in detail to the best of your recollection what inquiry you made in order to resolve in your mind the question so that you concluded that there was no danger from that conflict of interest? A. The information that I had from Smith; the information I had from Treloar; the fact that I had known of the pottery for some time and

(Footnote continued on following page)

Damages

In its opinion after the second trial the district court held that under the principle of unjust enrichment the actual profit received by Castle is the amount to be returned to Shenango. The court ordered judgment in the amount of $181,603.71, the amount of profit to Castle after renegotiation with the Price Adjustment Board. The plaintiff argues forcibly that the renegotiation was personal to Castle and should not be considered when determining the loss to Shenango; that Shenango could have made the same profit but because of its broader financial base the profit would not have been excessive. This fails to take into account that the $326,000 realized by Castle would be swelled by the $248,000 netted by Shenango on the production of the ceramic base and bell. Whether that would or would not have been renegotiated is speculative.

knew that they manufactured ceramics exclusively, and it was in my knowledge they never manufactured or assembled anything else. So far as going farther and asking questions, I asked no questions, but I felt that the information that had been furnished me and supplemented by the information of Mr. Zahniser at our meeting of March second, and supplemented by the unanimous resolution of the board of directors, as represented to me, satisfied me that the transaction was a good proposition for both Castle Engineering and Shenango Pottery.

Q. Then I think in the last answer you gave you were pushing the time back until after the directors' meeting. My question, Mr. Shumaker, was directed to what inquiry you made at the original conference concerning the land mine business on February 16 which was before that meeting took place on February 21. A. I accepted what Mr. Treloar and Mr. Smith told me about the arrangement which we have been discussing.

Q. Well, is it correct to say that on accepting the information given to you by Mr. Smith, Jr. and Mr. Treloar that you made no independent investigation or inquiry of your own? A. That is right. You mean at the time.

Q. At the time, which would be before February 21, 1944; is that correct? A. That would be correct."

The Renegotiation Act, 56 Stat. 245, 50 U.S.C. App. § 1191(4)(B), defines profits as "The excess of the amount received or accrued * * * over the costs paid or incurred with respect thereto." Excess profits have been defined as "those profits in excess of all the legitimate costs incurred in production, plus a normal profit, all of which are to be determined in accordance with designated formulas." Atkinson v. New Britain Mach. Co., 154 F. 2d 895, 904 (7 Cir. 1946). A method by which costs may be calculated is set forth in the Act. To determine the existence of excess profits, Section 4(A) requires consideration of six explicit factors and "such other factors * * * published in the regulations of the Board from time to time * * *." This Act was administered by the War Contracts Price Adjustment Board (50 U.S.C. App. § 1191(d)), now the Renegotiation Board (50 U.S.C. App. § 1217), which, like most other administrative agencies, was particularly adapted to the task for which it was created. On the other hand this court has no part in the actual renegotiation of wartime contracts. The Act provides that the Tax Court has exclusive jurisdiction to redetermine the amount of excess profit. 50 U.S.C. App. § 1191(c), (e). We possess no jurisdiction, except to review constitutional and jurisdictional questions. United States v. Martin Wunderlich Co., 211 F.2d 433 (D.C.Cir. 1954). What the plaintiffs seek is a determination by us whether the full profit in the hands of Shenango would have been renegotiated, and if so, in what amount. We could not do so with any degree of accuracy. Under the circumstances the loss to Shenango is at best a guess. It seems more equitable, and accurate, to award the amount by which the defendants were unjustly enriched; the renegotiated sum of $181,603.71.

On the second trial the district court also reduced the originally fixed rate of interest from 6% to 3%. The ruling was based on what "the sum involved would ordinarily have earned in the money market," during the period in-

volved. The court found that rate to be from 2½ to 4⅓% and concluded a rate of 3% would be fair. An excellent discussion of the trend of courts to fix interest at less than the legal maximum based on rates prevailing in the local money market is found in Speed v. Transamerica Corp., 135 F.Supp. 176, 199-201 (D.C. Del. 1955). On appeal we held that fixing the rate of interest is a matter peculiarly within the discretion of the court. 235 F.2d 369, 374 (3 Cir. 1956). The trial court in this instance used a correct standard in adjusting the rate. There was no abuse of discretion.

We have reviewed all of the remaining contentions of the parties, including the return of the salaries paid by Shenango to Smith, Jr. and Zahniser, defense of laches, and compensation sought for the services rendered by Treloar. The question of laches was passed upon in our prior opinion, 256 F.2d at 511. The other problems were properly decided by the trial court and need no discussion.

The judgment of the district court will be reversed as to defendants, Daniel H. Treloar, Jr., Zeno J. Pfau, Alvah M. Shumaker and John B. McCarty, individually, and as to Lynne Anderson Warren and Peoples First National Bank and Trust Co., as Executors of the Estate of James M. Smith, Jr., deceased, George B. Zahniser, Daniel H. Treloar, Jr., Zeno J. Pfau, John B. McCarty and Alvah M. Schumaker, trading as Castle Engineering Company, a partnership, and the case remanded to the district court with direction to enter judgment against all of said defendants and in favor of Shenango Pottery Company in the sum of $262,456.58.

The balance of the judgment of the district court will be affirmed. Costs to be taxed against the defendants.

A True Copy:

Teste:

Clerk of the United States Court of Appeals

Appendix B—Court of Appeals Judgment

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

ALICE S. HIGGINS (plaintiff), on behalf of herself and other stockholders of Shenango Pottery Company, similarly situated, and Hilda Barkby, Administratrix of the Estate of Harry Barkby, deceased (intervenor)

vs.

SHENANGO POTTERY COMPANY, now Shenango China, Inc., a corporation; James M. Smith, Jr., George B. Zahniser, Charles W. Read, Daniel H. Treloar, Jr., Zeno J. Pfau, John B. McCarty and Alvah M. Shumaker, individually and James M. Smith, Jr., George B. Zahniser, Charles W. Read, Daniel H. Treloar, Jr., Zeno Pfau, John B. McCarty and Alvah M. Shumaker, trading as Castle Engineering Company, a partnership; Lynne Anderson Warren and Peoples First National Bank and Trust Co., Executors of the Estate of James M. Smith, Jr., deceased

No. 13,026 and No. 13,027

ALICE S. HIGGINS, on behalf of herself and other Stockholders of Shenango Pottery Company, now Shenango China, Inc., similarly situated; and Hilda Barkby, Administratrix of the Estate of Harry Barkby, deceased,

Appellants,

No. 13,060

SHENANGO POTTERY COMPANY, now Shenango China, Inc., a corporation,

Appellant,

No. 13,061

LYNNE ANDERSON WARREN and Peoples First National Bank and Trust Company, Executors under the Will of James M. Smith, Jr., deceased,

Appellants,

No. 13,062

GEORGE B. ZAHNISER,

Appellant.

APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Present: McLAUGHLIN, KALODNER and HASTIE, Circuit Judges.

Appendix B—Court of Appeals Judgment

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Western District of Pennsylvania, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby reversed in part and affirmed in part, and the cause remanded with directions to proceed in accordance with the opinion of this Court. Costs to be taxed against the defendants.

Attest:

IDA O. CRESKOFF
Clerk

May 10, 1960

Received & Filed
MAY 10, 1960

IDA O. CRESKOFF,
Clerk

Appendix C—District Court Opinion

IN THE

District Court of the United States

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

ALICE S. HIGGINS, Plaintiff, on behalf of herself and other stockholders of Shenango Pottery Company, now Shenango China, Inc., similarly situated,

and

HARRY BARKBY, Intervenor

vs.

SHENANGO POTTERY COMPANY, now SHENANGO CHINA, INC., a corporation, and others,

Defendants.

CIVIL ACTION
No. 8432

OPINION

WILSON, District Judge

On April 26, 1956, in this shareholder's diversity action tried non-jury, findings of fact, conclusions of law, together with a discussion of the facts and principles of law involved were filed. During the trial before me and at the close of plaintiff's evidence, the action against three of the defendants, Pfau, Shumaker and McCarty, was dismissed under Rule 41(b). Plaintiffs appealed the dismissal as to the three-named defendants. The decision of the Court of Appeals reversing this court on the dismissal was handed down June 24, 1958. See *Higgins* v. *Shenango Pottery Company*, 256 F. 2d 504.

In the judgment entered by this court on April 26, 1956, Zahniser and the Smith, Jr. Estate were held liable to

Shenango in the sum of $316,603.71 plus interest at six percent running back to 1944. I found defendant Treloar not liable on the merits. However on application of defendants, a new trial was granted as to damages only, because it was felt that adequate consideration had not been given to the issue of damages in the trial of the case. Especially this court felt that further consideration should be given as to whether the renegotiated profits realized by Castle Engineering Company was the amount for which the defendants Zahniser and the Smith, Jr. Estate should be held responsible or whether the amount should be the gross profit of Castle before renegotiation. In March of 1959, the case again came on for trial on all remaining issues. On the issue as to the liability of Messrs. Pfau, McCarty and Shumaker, both sides presented evidence. Evidence was also presented as to the liability of defendant Treloar in view of the Court of Appeals' decision on this court's dismissal of Pfau, McCarty and Shumaker. The case against Treloar was open for all purposes because plaintiffs had pending and undisposed of motions for new trial as to the action against him. Also evidence was presented on the issue of damages, that is, the amount to which the plaintiff corporation was entitled, as well as the rate of interest and time from which the interest should be computed. At the second trial, the experienced counsel for the parties involved were given full opportunity to present their evidence on the disputed issues. Counsel were thereafter heard at oral argument and have filed their briefs which have been considered.

In reaching my decision, set forth herein, I have given full consideration to Judge McLaughlin's opinion, 256 F. 2d 504. As the facts have been found in detail in the adjudication filed April 26, 1956, and those findings having been buttressed by the evidence presented in the second trial, it is now felt that there is no present need to make detailed findings of fact and conclusions of law. The additional findings and conclusions necessitated as a result of the second trial

are found in this opinion as permitted by the provisions of Rule 52.

It is noticed that Judge McLaughlin says on page 508 of his opinion:

> "Since the orders of the district court do not set out the reasons motivating the dismissal, the only inference from the foregoing analysis is that the court found no liability made out against the partnership and therefore dismissed as to those defendants who could be liable only in their partnership capacity. Dismissal as to the other defendants must therefore have been denied because, though not liable in their capacity as partners, they could be held liable in their fiduciary capacities."

The foregoing quotation from the Court of Appeals opinion is the correct interpretation of this court's decision in dismissing the action against the three defendants named. In my prior discussion, page 28, I said:

> "The principles of law, as applied here, which hold Smith, Jr. and Zahniser liable to Shenango for the profits realized by Castle, exonerate Treloar and the other individual defendants. It is noticed again that the first information Treloar had regarding a land mine transaction was Smith, Jr.'s statement to him that Shenango had declined the opportunity. It bears repeating here that the decision by Shenango's board to decline the opportunity was made in good faith. There is certainly authority for the proposition that when a third person conspires with an officer to divert a corporate opportunity, he is as liable for the diversion as is the corporate officer. See *Jackson* v. *Smith*, 254 U. S. 586; *Irving Trust Co.* v. *Deutsch*, supra; *Austrian* v. *Williams*, 103 F. Supp. 64. See also *Restatement of Trusts*, Section 326, and *Restatement of Restitution*, Section 201. It is believed, however, that in this case Treloar had the right to rely upon the decision of the six members of Shenango's board. He was a complete stranger to Shenango. He engaged in no surreptitious activity with Smith, Jr.

to take the business away from Shenango. The policy of the law which defines the fiduciary's duties and obligations to the corporation and its shareholders, and under the facts here, requires that Smith, Jr. and Zahniser be held responsible, does not apply to a person in Treloar's position. The remaining individual defendants are in the same position as Treloar. It is noticed that Director Read was dismissed as a party defendant by stipulation of counsel. Some of the other defendants named were dismissed at the close of the plaintiffs' case. In any event, the individual defendants remaining in the case had lesser knowledge of the factual situation than Treloar and are not held liable in the decision reached."

It should be noticed here that Treloar's liability has not been passed upon by the Court of Appeals but he, being an active participant and one of the managing heads of Castle, is liable if anyone in Castle Engineering Company other than Zahniser and Smith, Jr. is to be held responsible. I have exonerated Treloar in my prior decision. I adhere to that decision. Zahniser and Smith, Jr. as officials and directors of Shenango were presented with a conflict of interest, and being fiduciaries under the statutory law of Pennsylvania they were precluded from participating in the Castle project. Whether their liability be founded upon a statute, or a breach of their fiduciary relationship to Shenango, or whether it is based simply on public policy, in any event it is not based upon fraud and deceit under the evidence in this case. For purposes of this discussion, their liability is in the nature of *mala prohibita* only. It should be stressed that there were six active directors of Shenango. The dominating personality on the Board, according to all of the evidence, was not Smith, Jr. but his father, James M. Smith, Sr. In no sense of the word could Zahniser and Smith, Jr. be characterized as dominant or controlling directors. On February 21, 1944, when the telephone call came from Smith, Jr., who was in the Ordnance Office at Pittsburgh, the others on the Board were called into session. They made the de-

cision for Shenango to submit the bid and to sub-let the assembly portion of the contract to Castle. At that point in the Board's deliberation on the question, the directors had the best interests of Shenango in mind and their decision turned out to be a profitable one in all respects. At that point, however, Zahniser and Smith, Jr. in the pursuit of this transaction were confronted with a stop sign. The law imposed upon them the duty of refraining from participating in the land mine transaction simply because it had been presented to Shenango. The question then arises whether the defendants, Treloar, Pfau, McCarty and Shumaker are contaminated by becoming partners with Zahniser and Smith, Jr. in the assembly of the land mines and thus liable for the profits made by Castle. I think the answer to the proposition stated is in the negative. That being so, it necessarily follows that Castle Engineering Company as a partnership entity is not liable.

The many decisions on this subject do not cover the precise point mentioned. It is noticed that the Restatement, Restitution, Section 201: "*Liabilities of Third Persons,*" refers to third persons doing business with fiduciaries and holds such a person liable "if he gave no value or if he had notice of the violation of duty." Counsel have cited no authority which goes so far as to hold that in the absence of fraud a person joining a director in a business enterprise turned down by the corporate directors becomes ipso facto liable to the corporation. In this situation, the authorities often stress the duty of making inquiry. On this feature of the present case, an inquiry by say defendant McCarty, who was a bartender by trade, would have disclosed the full information that the Board of Directors of Shenango had exercised their best business judgment in declining the opportunity in the first instance. It would also have disclosed that without being misled by Zahniser or Smith, Jr. or in any way being deceived by them, the Board at a later date concluded that the best interests of Shenango

were to be served by entering into the contract with the Ordnance Department and sub-letting a portion of the business to Castle. Defendants Pfau, and Shumaker a practicing attorney, knew of the foregoing factual situation and relying upon the directors' actions, joined in the Castle enterprise. Under the facts of the situation presented then, I conclude as a matter of law that the Castle partners, other than the two held liable, are not liable merely because of their association in the venture with Zahniser and Smith, Jr.

The point has been raised and also discussed in Judge McLaughlin's opinion that Castle partnership is liable because the assets of Shenango were in the first instance used as credit in establishing Castle as a going concern. It is true, of course, and the evidence shows, that once the venture commenced all the interested persons active in the management of both Shenango and Castle exercised their energies in all directions in order to make a success of the land mine contracts. Materials were difficult to procure. Shenango had ample credit. It was easy to do business in Shenango's name and that was done. But that method of operation was not a surreptitious one. No secret was made of it. From the commencement of the operation, it was just as much to the interests of Shenango that it be successful as it was to the interests of Castle. The venture proved a bonanza for Shenango as well as for Castle. The method of operation was done with the full cooperation of all members of Shenango's officers and directors. Judge McLaughlin in his opinion says on this subject:

> "They could not deal with the funds and property of Shenango nor utilize the information and advantage of their offices for any but the common good."

I hold that the method of doing business was for the

made a profit of $240,000 in less than one year on the transaction. Castle's profit before renegotiation was $316,603.71 and after renegotiation was $171,603.71. It is apparent therefore that the parties were in a business relationship in the nature of a joint venture or common enterprise. It should be observed, I think, that the parties were operating in war time. Conditions in business were far from normal. The individual plaintiffs in this case are far from generous in their appraisal of the motives of the Castle partners. Having heard all of the evidence, however, I am under the strong impression that the Castle partners were not only looking for a profit but also had a bona fide desire to further the war effort. The members of the Shenango Board were also motivated by the same considerations.

The evidence introduced in the second trial on behalf of defendants Pfau, McCarty and Shumaker showed that on their part, as individuals and partners, they had no voice in the inception of the transaction. They were merely innocent participants. It certainly appears unjust and inequitable that they be fastened with any of the liability incurred by Zahniser and Smith, Jr. At the conclusion of plaintiff's case, I concluded that there was no liability made out against these three defendants and after hearing their evidence, I am of the same conclusion. It is believed, however, that the case is in such posture that if the Court of Appeals disagrees with my evaluation and interpretation of the evidence then it may direct such a judgment as the evidence and the law requires.

Two matters remain for consideration. The first is the amount of the damages. In my prior decision, I concluded that the gross profit made by Castle, that is, $316,603.71, was the figure to be used but upon reconsideration of this matter and having in mind that what is presented is an issue of restitution because of unjust enrichment, I have concluded that the net figure after renegotiation is the

held liable. The evidence shows that on the first contract the gross profit to Castle was $148,541.13. This profit was reduced to $68,541.13. On the second contract before renegotiation, the profit was $168,062.58. After renegotiation the profit was reduced to $103,062.58. The total profit to Castle then amounted to $171,603.71. This figure is believed to be the one for which judgment should be entered in favor of Shenango against Zahniser and the Smith, Jr. Estate. If the principle is based on that of unjust enrichment, it must follow as a matter of logic that what was finally received as a profit is the sum to be returned to Shenango by the two defendants. Under the facts, the figure first paid to Castle by the government is simply a tentative amount subject to later renegotiation. It seems fair and just that the final settlement between he government and Castle should determine the amount of the liability. The final point for decision is the interest rate to be applied on the money found to be due and owing from Zahniser and Smith, Jr. Estate to Shenango and the date from which it should be computed. The cause of action is one founded on equitable principles. It is of course recognized that in breach of contract cases for damages incurred, the interest to be applied is the legal rate of six percent. See Wilson v. Homestead Valve Company, 217 F. 2d 792. It is believed however that in the instant case the application of equitable principles requires that the rate of interest be fixed at that rate which the sum involved would ordinarily have earned in the money market. The evidence shows that during the period involved, that is from 1944 to the present, Shenango could and did borrow considerable sums at interest rates ranging from two and one-quarter percent to six percent. The interest rate to be applied in this instance is not necessarily what Shenango paid for its loans but what the prevailing rate was in the Pittsburgh area. I find that rate to be from two and

comparable to the amounts involved here. I therefore conclude that Zahniser and the Smith, Jr. Estate should pay interest on money due Shenango at the rate of three percent per annum from the date that the profits were realized by Castle. Those dates were August 1, 1944 and November 1, 1944.

I have not overlooked the contention made by the defendants that the valuable services rendered by Treloar to Castle should be compensated for by way of reduction of the liability of Zahniser and Smith, Jr. I do not regard such a credit as proper under the facts of the situation. By the same token, I do not allow the defendants a credit because of the so-called $10,000 liquidation credit permitted the Castle partners in the computation of their income tax. Taxes paid by the various partners do not affect the liability of Zahniser and Smith, Jr. Further, plaintiffs sought to have the court surcharge the Smith Estate for the salary received by Smith during the period when he was devoting time to the Castle enterprises. This claim has been rejected because the evidence shows that Smith, Jr. also devoted time to Shenango's affairs and that Shenango during the same period of time did not suffer from any lack of attention by Smith, Jr. It was making a good profit. It is impossible under the evidence to divide up Smith's time between Shenango and Castle. It is believed in this respect that the plaintiffs had the burden of showing by the preponderance of the evidence that Smith, Jr. did not earn his salary paid by Shenango during this period. I find that plaintiff's burden was not met in this regard.